

# 2022

## BASIC FINANCIAL TERMS



B&SDS Division  
**SMEDA**

## Table of Contents

<b>1</b>	<b>Definitions of Basic Financial Terms .....</b>	<b>2</b>
<b>2</b>	<b>Financial Ratios.....</b>	<b>4</b>
2.1	Profitability Ratios .....	4
2.2	Liquidity Ratios .....	4
2.3	Asset Management Ratios.....	4
2.4	Debt Management Ratios.....	5

## 1 Definitions of Basic Financial Terms

### i. Required Rate of Return (RRR)

Required rate of return is the minimum rate, at which the amount of profit is calculated, that an investor expects for investing in a project in view of its risk profile.

### ii. Payback Period

The period in which the investment will be paid back by the project is called Payback Period.

### iii. Net Present Value (NPV)

NPV is the present value of all net cash flows, within the forecasted project life, discounted at the required rate of return. For calculating the NPV, all future cash flows are discounted to the start of the project and subtracted from the amount of initial investment. If the value of NPV is positive then the project may be considered as feasible.

### iv. Weighted Average Cost of Capital (WACC)

WACC indicates the average cost of capital from possible sources of funds; including owner's investment, stocks, bonds, and other forms of debt and loans.

### v. Internal Rate of Return (IRR)

In simplistic terms, IRR is the rate at which NPV equals to zero. In other words, the rate at which discounted net cashflows pay off the initial investment in the project.

It is a tool to find out the profitability of a given investment over a period of time. Higher the IRR, higher is the probability of generating profits through the project. IRR is usually compared with WACC such that IRR should be higher than the weighted average cost of capital.

### vi. Capital Investment

Capital investment is the amount invested in a company to start operations of a business. It is the money used to purchase fixed assets such as land and building, machinery and equipment etc. The money may be in the form of cash, assets, or loans.

As the business grows, capital investment can be further injected in the business to purchase additional capital assets. Capital investment is not used to cover the business's day-to-day operating expenses.

### vii. Working Capital

Working Capital refers to money invested in current assets of the business, such as; cash, accounts receivable, inventory, marketable securities and short-term securities. In short, working capital is the money available to meet your current day to day expenses and short-term obligations such as paying your employees and vendors etc.

### viii. Human Resource

Human resource is the set of people who make up the workforce of an organization, business, sector, industry, or economy. Human resource is also considered as human capital of a

business such as the knowledge, skills and abilities which the individuals have. Human resource includes manpower, labor, employees, workers, personnel, and associates etc.

#### **ix. Mark-up Rate**

Markup rate is the rate of interest charged by a bank or any other lending institution for a loan acquired by the business.

#### **x. Cost and Revenue**

Cost means all the expenses a business incurs to produce units of its products or in providing services. Similarly, revenue means income earned by the business by selling the units of products or services.

#### **xi. Financial Statements**

Financial statements are reports that summarize a business's asset and liabilities status, income and profit earned and its cash flows during a specified period of time. Primarily, financial statements include income statement, balance sheet, and statement of cash flows.

##### **a. Income Statement**

Income statement reflects upon the outcome of business operations and financial activities for the reporting period. It usually contains results for either the past month or past year, and may include several periods for comparison purposes. Its general structure begins with revenues generated, from which cost of goods sold are subtracted, followed by deduction of selling, general, and administrative expenses. The result is either a profit or loss after deduction of taxes.

##### **b. Balance Sheet**

Balance sheet indicates a business's assets, liabilities, and shareholders' equity as of the reported date. The total of all assets must equal the combined total of all liabilities and equity, this is also known as the accounting equation. Information on assets is subdivided into current and long-term assets on the balance sheet. Similarly, information on liabilities is subdivided into current and long-term liabilities.

##### **c. Cash Flow Statement**

Cash flow statement reflects the changes in a business's cash inflows and outflows during a reporting period. Cash flows are categorized into cash flows from operating activities, investing activities, and financing activities.

Cash flows listed in the operating activities section reflect operations of the business, such as changes in receivables, inventory, and payable balances. The section for investing activities contains cash flows generated from the purchase or sale of investments, assets or other businesses. The 'financing activities' section contains cash flows related to the acquisition or pay down of debt, dividend issuances, stock sales etc.

## 2 Financial Ratios

Financial Ratios are used to analyze financial performance of a business. Generally four basic types of ratios are used to assess the health of a business: Profitability, Liquidity, Asset Management and Debt Ratio.

### 2.1 Profitability Ratios

Profitability ratios measure the firm's use of its assets and control of its expenses to generate an acceptable rate of return.

#### a. Return on Assets (ROA)

ROA indicates how efficiently your business generates income using its assets.

#### b. Return on Equity (ROE)

ROE is a measure of the management's ability to generate income from the equity available to it. It is mostly used for comparing performance of companies in the same industry.

#### c. Return on Investment (ROI)

ROI is used by investors to calculate returns received for a particular investment as a proportion of the originally invested amount.

### 2.2 Liquidity Ratios

Liquidity ratios measure the availability of cash to pay your liabilities.

#### a. Current ratio

Current ratio indicates the availability of current assets to pay off short-term liabilities. Current assets include debtors, advances/prepayments, stores and spares, stock, cash in hand, cash at bank, cash equivalents and other receivables. Whereas, current liabilities include creditors, short term loans, Interest payable, bank overdraft and other payables.

#### b. Quick ratio

Quick ratio also known as Acid-Test Ratio measures how quickly a company's short-term liquid assets can cover current liabilities. Liquid assets include only those current assets which can be readily liquidated; such as cash, cash convertibles, short term loan and debt. Inventory is considered to be an asset that requires time for liquidation and hence is excluded from the quick ratio.

### 2.3 Asset Management Ratios

Assets management ratios also called 'activity ratios' or 'efficiency ratios', measure the effectiveness of business's use of its resources and assets.

#### a. Inventory turnover ratio (days)

Inventory turnover is the rate at which inventory stock is sold / used / replaced. The ratio provides the number of days in which the inventory will be turned over.

**b. Days sales outstanding (days)**

Days of sales outstanding (DSO) is a measure of the average number of days that it takes for a company to collect payment after a sale has been made.

**c. Fixed assets turnover ratio (days)**

Fixed asset turnover ratio reveals how efficient a company is at generating sales from its existing fixed assets.

**d. Total assets turnover ratio (days)**

The asset turnover ratio, also known as the total asset turnover ratio, measures the efficiency with which a company uses its assets to generate sales.

**2.4 Debt Management Ratios**

Debt or leverage ratios measure the firm's ability to repay long-term debt.

**a. Debt ratio**

A debt ratio measures the ability of a business to pay its debt with available total assets. It is calculated by dividing total debt with total assets. It reflects the amount of short term and long term taken on by a business to finance its current and fixed assets.